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# Intelligence Memorandum

*Italy: The Political and Economic Scene in Fall 1976*

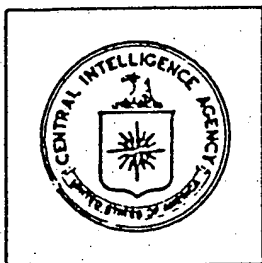
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## Italy: The Political and Economic Scene in Fall 1976

The Christian Democratic minority government installed last month symbolizes the political changes that have occurred in Italy since the parliamentary election in June. Although the Christian Democrats again scored a plurality in the election, they have lost their ability to dominate the political scene because of (a) sharp electoral gains by the Communist Party and (b) intransigence of the Christian Democrats' traditional allies—most notably the Socialists, who cling to their campaign promise not to join any government that relegates the Communists entirely to the opposition. As a result, Prime Minister Giulio Andreotti had to bargain for Communist abstention to win a parliamentary vote of confidence for his new government. The Communists have parlayed their pivotal position into unprecedented influence but also have incurred some serious risks by diluting their longstanding opposition status.

The enhanced role of the Communists further complicates the always difficult task of formulating economic policy in Italy. Prime Minister Andreotti must strive for consensus among parties with diverse economic philosophies, and his program thus gives only broad-brush treatment to Italy's myriad economic problems. In coming months, specific measures will have to be hammered out in parliament; many, such as an incomes policy, will be hotly contested.

Because of the need to please everyone, the government will probably decide eventually on a mildly deflationary stabilization program that will neither bring inflation into line with trends in other European countries nor abort the economic recovery now under way. Although the main outline of the economic program undoubtedly will closely resemble previous center-left programs, the increased influence of the Communists in important parliamentary committees should guarantee a greater degree of followthrough than in the past. This is especially true

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for oft-repeated but previously unfilled promises of social improvements and curbs on tax evasion.

In coming months, the Christian Democrats will try to revive ties with the smaller parties in an effort to escape dependence on the Communists. At the same time, the Communists will attempt to build on the Andreotti experiment to move closer to actual government membership. Any success in the economic field, and there will be some, will add pressure for expansion of the limited rapprochement between the two largest parties. ~~While the game is not over,~~ there are more factors favoring the realization of Communist party chief Berlinguer's "Historic Compromise" than at any time since he launched the proposal in late 1973.

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## DISCUSSION

1. Italian politicians are now maneuvering on a political landscape vastly different from the one that existed prior to the sharp Communist electoral gains in June. Before the parliamentary election, the basic characteristics of Italian politics were as follows:

- the Christian Democrats, Italy's largest party by a wide margin, played the dominant role in the government,
- the Communists, the second largest party, dominated the opposition, and
- the remaining parties, except for the neofascists and other fringe groups, alternated as supporters or coalition partners of the Christian Democrats.

2. Giulio Andreotti's difficulties in putting together his Christian Democratic minority government demonstrate how sharply the election outcome has altered the traditional political picture. Although still the largest party, with 38.7% of the vote, the Christian Democrats no longer dominate the political arena. Because of the poor showing by the smaller parties and the steep gains scored by the Communists—from 27.2% of the vote in 1972 to 34.4% this year—Andreotti could win a parliamentary confidence vote only with Communist abstention.

3. Communist abstention, in turn, blurred that party's traditional opposition status, the more so because it allowed Andreotti's installation. With the Communists not voting, the Christian Democrats would have won a majority even if all the other parties had voted against Andreotti. Indeed, none of the smaller parties once allied with the Christian Democrats supported them in the confidence vote. The Socialists, Social Democrats, Republicans, and Liberals chose instead to join the Communists in abstaining.

4. Andreotti's government is thus a transitional experiment that breaks most of the old rules. All Italian politicians, including Andreotti, acknowledge the government's temporary nature. They nonetheless will differ sharply in the coming weeks over what should replace it.

5. Most Christian Democrats will try to rebuild ties with former coalition partners in the hope of reviving some semblance of the old order. The Communists, on the other hand, will attempt to use the Andreotti experiment to move closer to

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actual government membership. What finally happens will depend not only on internal and interparty dynamics but also on how well the Andreotti government performs.

### The Communists

6. The Communists face unprecedented opportunities along with some serious risks. They are the only party to gain substantially from the lengthy maneuvering prior to Andreotti's installation.

7. When it became apparent that Communist cooperation would be essential to forming a government, the party was able to press successfully for key parliamentary posts that had previously been the preserve of the governing parties. An experienced Communist legislator became president of the Chamber of Deputies. The Communists also obtained the presidencies of 7 of 26 permanent parliamentary committees.

8. These posts will probably give the Communists more influence in domestic policy than would a couple of minor cabinet portfolios—although the latter would carry more symbolic importance. By chairing the Chamber's Finance Committee and the Senate's Budget Committee, for example, the Communists will strongly influence all economic and fiscal legislation. These committees have the authority to review and change all bills before they are debated on the floor. Committee presidents, moreover, can slow down or speed up the progress of any bill.

9. Andreotti will have to take Communist views into account on other matters as well. Parliamentary arithmetic gives the Communists the power to defeat any bill—or even bring down the government—unless there is offsetting support from the Christian Democrats' former allies.

10. The Communists have paid a high price, however, for their new influence. ~~No amount of Communist rhetoric about the inadequacies of Andreotti's government can hide the fact that the Communists permitted it to be installed.~~ Although the Communists will disclaim responsibility for anything that goes wrong, they cannot credibly assert—as they have frequently in the past—that their hands are "clean." It is already clear that many militants are uneasy over the party's new role. Communist chief Berlinguer's most recent major address was an obvious attempt to reassure the rank and file that the party has not abandoned its traditional goals or sold out to the Christian Democrats.

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11. The Communists have thus invested considerable political capital in the government and would have little to gain from frustrating Andreotti's program or from bringing him down prematurely. Indeed, it would be in their interest to ensure that something positive emerges. Andreotti's early failure could damage the party's reputation as a force for progress and dampen the enthusiasm of its supporters. Although the Communists will drive hard bargains in any negotiations with Andreotti, they will also look for points of convergence that would justify more progress toward party chief Berlinguer's "Historic Compromise"—an eventual governing alliance with the Christian Democrats.

#### The Christian Democrats

12. The Christian Democrats' dilemma will severely test the party's cohesion. On the one hand, the governing party needs Communist cooperation to accomplish anything; on the other hand, it hopes to lay the groundwork for another coalition that shuts out the Communists.

13. In the past, the Christian Democrats have consulted the Communists informally to secure cooperation on specific issues. The distribution of parliamentary committee presidencies alone now ensures that such consultations will be more overt and formal. Each committee chaired by a Communist in one house, for example, is chaired by a Christian Democrat in the other house, forcing the two parties into closer liaison to secure legislation. ~~Under these circumstances, Andreotti will have to walk a thin line in striving for another non-Communist coalition. His party's strongest card in this game may be its former allies' fear that continued intransigence could lead to a formal Christian Democratic alliance with the Communists.~~

14. ~~The Christian Democrats also have serious internal problems. Pressures are mounting for organization reforms, leadership changes, and new programs to dispel the image of a tired and corrupt organization and to take the initiative away from the Communists. For the moment, most Christian Democrats seem willing to accept limited cooperation with the Communists to keep Andreotti afloat. If the Communists seem on the verge of a larger role, however, some influential Christian Democrats may begin a behind-the-scenes campaign to bring Andreotti down.~~

#### The Socialists

15. Christian Democratic efforts to escape dependence on the Communists will focus on the Socialists—the only party that can guarantee the Christian Democrats a non-Communist majority in parliament. The Socialists have been

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unable to capitalize on their pivotal position, however, and were clearly the major losers in the postelection maneuvering. Stung by their failure to advance in an election they precipitated, the Socialists were little more than passive participants in the bargaining that led to the Andreotti government.

16. The Socialists' failure in the election plunged the party into a leadership struggle. Veteran leader De Martino was quickly replaced by 42-year-old Bettino Craxi, who comes from the party's right wing and is inclined toward seeking a deal with the Christian Democrats. Craxi does not yet command a stable majority, however, and is still tied by the party's campaign promises of (a) short-term support for a broadly constituted emergency government including the Communists and (b) long-term support for an "alternative of the left."

17. The Christian Democratic hope that Craxi will turn his party around and lead it back into coalition will take months to fulfill, if it can be fulfilled at all. The Socialist Party's fundamental task is to maintain viability in the face of the voters' surge toward the Communists. Although most members do not want to share cabinet posts with the Communists, the Socialists have concluded that the Communist Party will have an electoral advantage if it remains entirely in opposition.

18. The Socialists are likely to cling to at least a vestige of their demand for Communist association with the government. As a condition for renewed participation in the government, for example, they may insist that the Christian Democrats agree to continue formal consultation with the Communists on government programs.   ~~he Socialists will at least insist that the Communists continue to abstain in parliamentary voting.~~

#### Changing Rules of the Game for Economic Policy

19. The Communist Party's new strength has further complicated the delicate balancing act the Christian Democratic leadership must play in the formulation of economic policy—a process long hampered by Italian political divisions.

20. Lacking a solid majority, Christian Democratic leaders in recent years have had to put together programs that would not only satisfy the major factions of their own heterogeneous party but also command the support of the Socialists, Republicans, and Social Democrats. The Socialists, fearful of vote losses to the Communists, have regularly rejected measures that would check union power or slow the growth of workers' real earnings. They have favored permissive labor

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legislation and greater spending for social projects. At the other extreme, the Republicans, always rigid advocates of free enterprise and fiscal conservatism, have emphasized their opposition to further enlargement of the state sector. The Social Democrats stand between the Socialists and Republicans—eager for social reform but suspicious of growing government involvement in the economy. The economic programs that have emerged after numberless compromises and trade-offs have lacked the punch needed for effectiveness.

21. Under the new political circumstances, formulating an economic program is even more difficult. Economic policies must now be acceptable to the Communists, divergent views within the Christian Democratic Party must be reconciled, and the Republicans, Social Democrats, and Socialists must be mollified. Furthermore, Communist parliamentary strength on the one hand and internal Christian Democratic politics, combined with pressure from foreign creditors, on the other dictate that the government attain Communist compliance on key economic measures without soliciting formal Communist support.

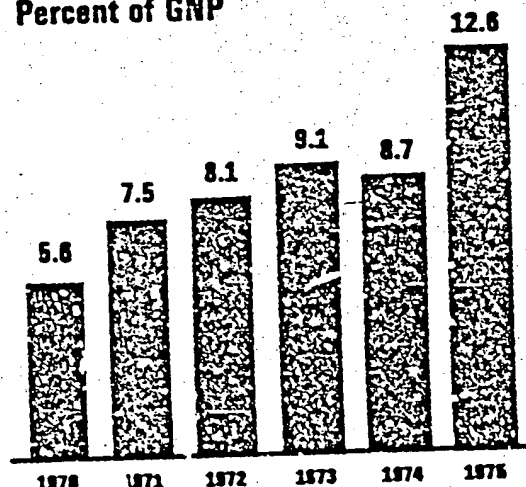
#### The Economic Program

22. The Andreotti economic program, as presented to the Senate and Chamber of Deputies for the confidence vote, aims at political consensus. It is skillfully tailored to offer something for everyone. For the Communists and Socialists, there are curbs on tax evasion, more active employment programs, and greater spending for social investment. Promises of smaller government deficits, more efficiency in the state sector, and modification of wage indexation are designed to woo the Social Democrats and the Republicans.

23. Basically, the program seeks to stabilize the economy by reducing the government deficit, gearing down the wage indexation system, and making industry more competitive. Program priorities include the following:

- Reducing the Treasury cash deficit from 12.6% of gross national product (GNP) in 1975 (see Figure 1) to 4.2% by 1979, while increasing investment in public works to 5%-6% of GNP from the

Figure 1  
Italy: Treasury Cash Deficit as  
Percent of GNP



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present 1% level. Andreotti is calling for a crackdown on tax evasion and hikes in public service charges. He hopes to slow expenditure growth by limiting new programs, canceling some appropriations previously approved, and freezing high-level government salaries.

- Closing the balance-of-payments gap through an energy conservation program, increased value added taxes on imported consumer goods, and renegotiation of existing foreign debt. The program will also seek to raise agricultural production to reduce Italian dependence on imported food.
- Modifying the wage indexation system by progressively reducing cost-of-living allowances for medium to high wage earners and terminating allowances for salaries above a certain level.
- Improving the efficiency of state enterprises by establishing company goals, improving management, and diversifying and decentralizing managerial responsibility.
- Increasing employment by providing public service jobs and apprenticeships in private industry for youths and first-time job seekers, who account for 80% of the unemployed.
- Improving industrial competitiveness by restructuring small businesses, curbing worker absenteeism, and rescheduling labor holidays.

#### Prospects for Enactment

24. The Andreotti program thus far merely lists economic goals and gives broadbrush treatment to the difficult choices facing Italy. In subsequent months, as parliament hammers the program into a series of specific measures, obstacles will appear. Some points of the program—such as the crackdown on tax evasion—can expect easy passage. Others—such as increases in public service charges and modifications to the wage indexation system—will be hotly contested.

25. The fiercest conflict will center around wage indexation. Christian Democratic economists—prompted by Republicans—now acknowledge the cost-push impact of the present indexation system as a crucial factor in Italy's inflation. Under the present arrangement, price increases bump up wage rates after a lag of about three months. This year wages in industry will certainly rise more than 20%, mainly because of such cost-of-living increases; contract settlements will provide basic wage

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increases of only 6.5%-8%. Moreover, the impact of indexation is increasing. At present, cost-of-living allowances cover about 70% of inflation; and contracts already negotiated guarantee that coverage will rise to 90% next year unless the formula is changed.

26. The trade unions will bitterly resist any major revision of the indexation machinery. Andreotti's proposed progressive reduction of cost-of-living allowances for earners of medium to high salaries bypasses a union proposal that salaries above \$10,000 be frozen—a move that would concentrate the burden of inflation on only 10% of the work force and do little to slow the rise in unit labor costs. Andreotti's ability to sell a substantial revision of the wage indexation machinery to the unions will depend largely on whether the Communists are willing to exert their influence with labor on behalf of such a proposal. The Communists have long contended, however, that wage restraint must come from the unions themselves and will be reluctant to pressure the unions on this issue. The Socialists, eager to take support away from the Communists, will probably encourage the unions in their opposition to changes in the indexation mechanism.

27. Curbs against absenteeism and rescheduling of public holidays would be politically more acceptable means of reducing pressure on unit labor costs. Legislation passed in 1972 making it illegal to require medical verification of sick leave has made absenteeism endemic. On an ordinary day, absenteeism averages 13.7%, compared with 6.7% in France and 6.8% in the United States. When a holiday falls on a Tuesday or Thursday, attempts to eke out a long weekend drive absenteeism rates up to 40%. The Christian Democrats and the Republicans view absenteeism as an obstacle to Italy's competitiveness, while the Communists call it a sign of "moral degeneration." Unions appear willing to discuss the absenteeism issue if it is linked to government measures to increase employment.

28. Thanks primarily to slowed expenditures and speeded up tax collections, Rome should be able to meet the Treasury deficit guidelines imposed by the European Community last April when it extended a \$1 billion credit. During the first five months of this year, the Treasury cash deficit amounted to 4.0 trillion lire (\$4.7 billion at current exchange rates), 25% below the same period last year and well within the 13.8 trillion (\$16.5 billion) ceiling set for all 1976 by the EC. The concern is for next year, when spending already in prospect and a return to normal rates of revenue collection threaten to increase the deficit sharply.

29. The major parties seem in agreement on attacking the deficit by focusing on the revenue rather than the expenditure side. As a percentage of GNP, expenditures are on a par with those in other industrial countries; revenues, however, lag far behind. The 1973 and 1974 tax reforms, which instituted the value added tax and new corporate and personal income taxes, have had disappointing results because of widespread evasion.

30. Of the various fiscal proposals, action against tax evasion will have the broadest support. The program promises to cut business tax evasion by close scrutiny of corporate books and by using banks as collection agencies. Income tax evasion is to be fought through selective audits and use of computerized tax rolls. Communists and trade union leaders have long decried tax evasion as a source and symbol of social injustice. In the past, the Christian Democrats have also waged campaigns against tax shirkers, albeit with little effect. Because the Communists chair the Finance and Treasury Committee in the Chamber of Deputies and the Budget Committee in the Senate, the present government will be under greater pressure to achieve concrete results.

31. Proposals to hike tariffs on public services to cover operating costs will be more divisive politically. The urban worker long has viewed subsidized transportation, electricity, home heating, and water rates as a national right. Risking further wrath, the Andreotti proposal would not allow increases in public service tariffs to boost wages through cost-of-living escalators.

32. The Communists—who have long asserted that lower income groups should not bear the brunt of stabilization—will strongly contest any substantial hikes in public service charges. The Socialists will take a similar position. In contrast, the Christian Democrats and the Republicans support such hikes. A large share of state expenditure represents subsidies to hold down “political prices”; in recent years, loans and advances to autonomous agencies—notably the railroads, post office, and road authorities—have been among the fastest growing contributors to the Treasury deficit.

33. To recoup an estimated \$700-\$800 million in revenue that will be lost by a Supreme Court decree declaring joint income tax returns unconstitutional and to satisfy union demands for income equality, Andreotti will probably propose higher tax rates on salaries above a certain level. Thanks to Communist and Socialist

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support, this blow to upper income groups should pass easily despite strenuous objections from the Republicans and parties further to the right.

#### Shape and Implications of the Eventual Stabilization Plan

34. If the Andreotti government holds out through the lengthy period of bickering and maneuvering, the parties will probably settle on a mild stabilization program. Higher taxes on upper incomes and action against tax evasion will provide the main deflationary elements. Public service tariffs will probably be hiked, though not nearly enough to cover operating expenses. Increased value added taxes on luxury imports—a favorite issue of the Communists and Socialists—may also be imposed to alleviate the trade deficit.

35. Whatever action is finally taken against rising unit labor costs will probably be directed at the productivity side—through curbs on absenteeism, for example—rather than at wage levels. Given the opposition of the Communists, the Socialists, and the trade unions, no comprehensive incomes policy or major overhaul of the indexation system can be expected. If any limits are imposed on salaries, they probably will apply only to the upper end of the income scale.

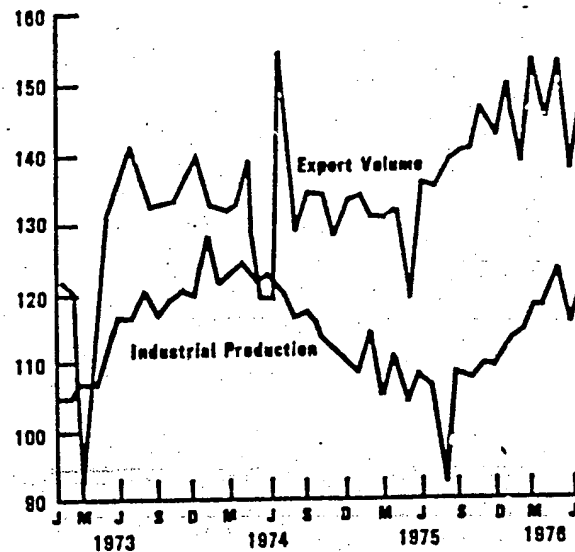
36. Under a mild austerity program, GNP growth—which is expected to slow from the 6.6% annual rate of first half 1976 to perhaps a 2.5% rate in the second half—would reach roughly 3% in 1977. (In the likely event that OPEC raises prices by 15% this December, Italy's growth rate could fall as low as 1.5% next year unless compensating action can be taken.) Exports will have to provide the main stimulus for growth. Export volume already has risen 6.6% (seasonally adjusted) since the end of 1975, helping to induce an 11.9% rise in industrial output (see Figure 2). The sharp devaluation of the lira and continuing world recovery now under way should keep export demand strong. Although consumer spending in first quarter 1976 was 5% higher than in the corresponding period last year, gains of a smaller magnitude can be expected as fiscal measures take hold.

37. As the Bank of Italy supplements fiscal action with tight monetary policy, investment will remain the softest spot in the economy. High interest rates, low profitability, and political uncertainty already have combined to depress investment; first quarter spending on gross fixed investment was 6% below 1975

## Italy: Selected Economic Indicators

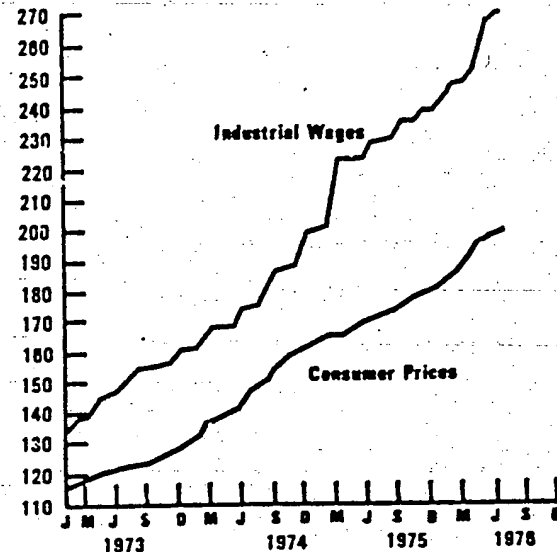
### Industrial Production and Export Volume

Index: 1970=100, seasonally adjusted



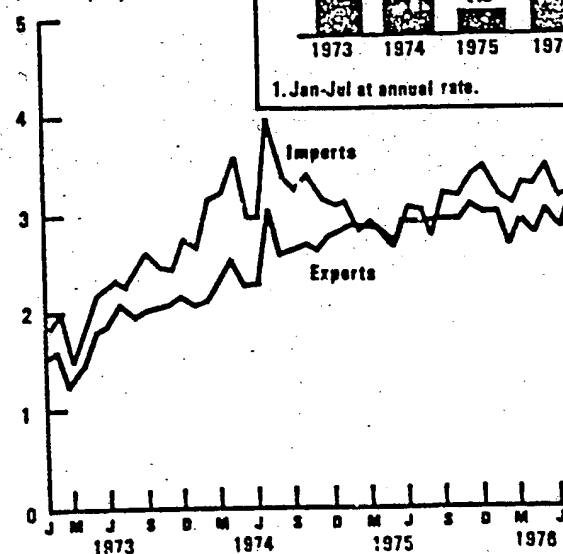
### Prices and Wages

Index: 1970=100, not seasonally adjusted



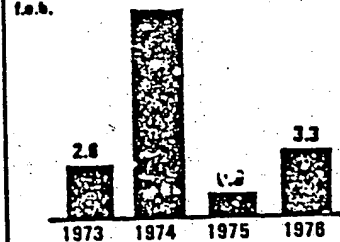
### Foreign Trade

Billion US \$, f.o.b., seasonally adjusted



### Trade Deficit<sup>1</sup>

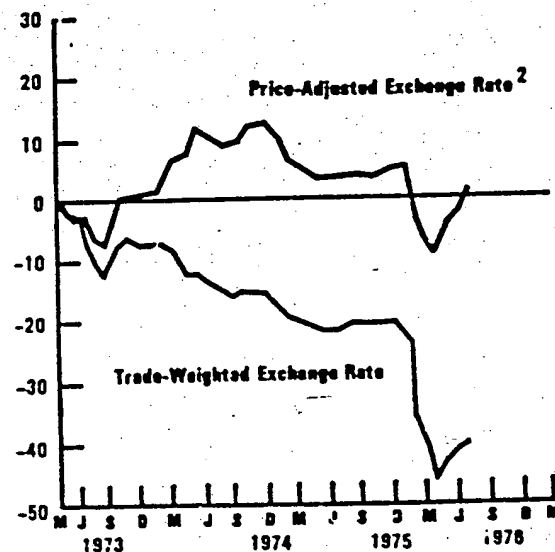
Billion US \$  
f.o.b.



1. Jan-Jul at annual rate.

### Trade-Weighted and Price-Adjusted Exchange Rate<sup>1</sup>

Percent



1. Compared with 19 March 1973.

2. Trade-weighted exchange rate adjusted for changes in Italian wholesale prices relative to those in trading partners. An increase in the price-adjusted exchange rate implies a decline in competitiveness.

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levels. With capacity utilization still low and credit remaining scarce, investment growth should average only 5% over the next year or so—a very slow pace compared with past recovery periods.

38. Barring a more active government employment policy ~~than we foresee~~, the jobless rate will remain a hot political issue. Because trade union strength and labor legislation make it extremely difficult to lay off workers, Italian firms are reluctant to expand employment despite rising demand. If recovery brings any improvement in the labor market this year, it will probably be reflected in a reduction in the number of workers on reduced work schedules rather than any decrease in the unemployment rate. According to a survey by Confindustria—the Italian manufacturing association—industrial employment levels are expected to remain relatively flat this year and to make only slight gains next year. With continued labor force growth, unemployment should continue to rise into 1977.

39. With the government unable to enact an effective incomes policy or scale down the indexation machinery, inflation will remain troublesome. Sparked by the *de facto* devaluation of the lira, consumer prices soared at an annual rate of 30% in the first half compared with the first half 1975. Although the June and July increases in the consumer and wholesale price indexes—averaging 0.5% and 1.2%, respectively—suggest a moderating trend, cost-push factors assure that price hikes will continue to outstrip those in other major industrial countries. Upward adjustments in public service charges of the type envisioned in the Andreotti program would force up consumer prices even more.

40. Tight credit, the import deposit scheme, and the Christian Democrats' retention of their plurality temporarily reduced foreign exchange pressures. Indeed, the lira's firmness after the June election allowed the Bank of Italy to intervene in the market to buy back about \$1.5 billion in foreign currency. The Bank repaid its outstanding swap arrangement with the United States and rolled over only \$1.5 billion of the \$2 billion credit owed to Bonn. However, in late September the lira once again came under downward pressure, prompting the central bank to sell foreign exchange to prop up the sagging currency and impose additional curbs on bank liquidity. Another lira crisis could easily develop if disagreement over the stabilization program results in Andreotti's collapse.

#### Outlook

41. Although Andreotti could stumble at any time, the absence of alternatives should keep his government in place at least until late fall or early

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winter. Perhaps the major determinant of this government's lifespan and the next one's complexion will be the relationship that develops between the Christian Democrats and the Communists as Andreotti seeks legislation to implement his economic program.

42. While the stabilization program itself will probably be mild, there seems to be greater likelihood of followthrough than in the past. With the Communists in a pivotal position, some essential economic reforms—such as curbs on tax evasion, greater spending on social priorities, and reform of state-owned enterprises—stand a better chance of enactment. The Communists may also use their influence to secure productivity-improving concessions from labor unions.

43. If such a program succeeds even partially and is viewed mainly as a byproduct of Christian Democratic-Communist cooperation, pressure will build for closer relations between the two parties. Working in the opposite direction will be the Christian Democrat's unequivocal campaign pledge not to bring the Communists into the government. The non-Communist majority, however, is divided and disorganized, and the Christian Democrats will not be able to hold the line for long unless they can find the basis for a new non-Communist alliance.